DEPARTMENT OF STATE REVENUE

04-20110287.LOF

Letter of Findings: 04-20110287
Gross Retail Tax
For the Years 2008, 2009, and 2010

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ISSUES

I. Subpoena Authority – Gross Retail Tax.

Authority: IC § 6-2.5-9-8; IC § 6-8.1-3-12; IC § 6-8.1-5-1(b); IC § 6-8.1-5-4.

Taxpayer argues that the assessment of sales/use tax is defective because the Department failed to obtain a subpoena requiring Taxpayer to produce its financial books and records.

II. Reasonable Cause – Gross Retail Tax.

Authority: IC § 6-2.5-1-2; IC § 6-2.5-2-1(a); IC § 6-2.5-2-1(b); IC § 6-2.5-3-1(a); IC § 6-2.5-3-2(a); IC § 6-2.5-4-1(b), (c); IC § 6-8.1-5-1(b); IC § 6-8.1-5-1(c); Rhoade v. Ind. Dep't of State Revenue, 774 N.E.2d 1044 (Ind. Tax Ct. 2002); USAir, Inc. v. Ind. Dep't of State Revenue, 623 N.E.2d 466 (Ind. Tax. Ct. 1993).

Taxpayer maintains that the assessment of sales/use tax is flawed because the Department did not have the requisite "reasonable belief" that the Taxpayer ever owed additional tax.

III. Statutory Authority – Gross Retail Tax.

Authority: IC § 6-2.5-1-2; IC § 6-2.5-2-1(a); IC § 6-2.5-3-2(a); IC § 6-2.5-4-1(b), (c); IC § 6-8.1-5-1(c).

Taxpayer states that the assessment of sales/use tax is erroneous because the Department assessed "use" tax on the March 2011 audit "summary" report but issued notices of "Proposed Assessment" which purportedly mislabeled the assessment as "sales" tax.

IV. Calculation Error – Gross Retail Tax.

Authority: IC § 6-8.1-5-1(b); 45 IAC 2.2-5-8(j).

Taxpayer argues that the Department's audit "summary" contains calculation errors and errors in interpreting the information contained on Taxpayer's federal tax returns.

STATEMENT OF FACTS

Taxpayer is an Indiana business which manufactures heating and air conditioning equipment for industrial and warehouse facilities. The Indiana Department of Revenue (Department) selected Taxpayer for a sales and use tax audit. Taxpayer and the Department's efforts to schedule an appointment to review Taxpayer's records were unsuccessful. As a result, an "audit [was] performed based on the best information available."

Taxpayer disagreed with the proposed assessment of additional sales/use tax and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer's representative explained the basis for the protest. This Letter of Findings results.

I. Subpoena Authority – Gross Retail Tax.

DISCUSSION

Taxpayer maintains that the Department failed to follow the procedures necessary for initiating an audit. Specifically, Taxpayer maintains that the Department was required to issue a subpoena for Taxpayer's records and, if necessary, to petition a local court if competition jurisdiction for an order requiring Taxpayer to produce those records. Since the Department failed to obtain either a subpoena or court order, Taxpayer believes that the assessment should be abated.

In order to understand Taxpayer's objections, it is useful to set out a "time-line" of the steps taken by the Department's auditor and the Taxpayer's representative to review Taxpayer's books and records.

- In July 2010, the Department's auditor contacted Taxpayer by regular mail scheduling an audit to begin August 2010.
- In August 2010, the Department's auditor contacted Taxpayer to confirm that the audit was set to commence that month.
- Taxpayer responded by asking for a "Power of Attorney" (POA-1) form and indicating that personal matters prevented Taxpayer from participating in an August 2010 audit. In addition, the Taxpayer indicated that it 'ha[d] questions and concerns" which required a response before proceeding with the audit.
- Taxpayer returned the POA-1 designating a representative to act on its behalf.
- The Department's auditor contacted the Taxpayer's representative to discuss the questions and concerns raised and to reschedule the audit examination. The Taxpayer's representative indicated that he would respond the following day.
- One day later, the Department's auditor called Taxpayer's representative; the Department's auditor was unsuccessful in speaking directly with Taxpayer's representative but sent an email to confirm the attempts to do so.

• Eight days later, having failed to receive a response from Taxpayer's representative, the Department's auditor sent another email in an attempt to respond to Taxpayer's questions and concerns.
• Sixteen days later, having failed to receive a response from Taxpayer's representative, the Department's auditor sent another email to Taxpayer's representative.
• Six days later, having not received a response from Taxpayer's representative, the Department's auditor sent another email to Taxpayer's representative.
• Thirty-five days later, the Department's auditor received a message from the Department's district office indicating that Taxpayer's representative had contacted that office. Thereafter, the Department's auditor unsuccessfully attempted to contact the representative but left a voice message indicating the attempt to do so.
• Four days later, the Department's auditor called the representative leaving another voice message.
• Four days later, the Department's auditor contacted Taxpayer's representative by email indicating that unless other arrangements were made, the audit would be conducted at the end of October.
• Six days later, the Department's auditor received a message from the Department's district office indicating that Taxpayer's representative had contacted the district office directly. The Department's auditor called Taxpayer's representative and left a voice message.
• Fifteen days later, the Department's auditor received a letter from Taxpayer's representative indicating that Taxpayer would be unable to participate in an October audit.
• Sixteen days later, the Department's auditor replied in writing to the Taxpayer's representative.
• Twenty-nine days later, the Department's auditor called Taxpayer's representative leaving a message indicating that the auditor "Need[ed] to find out what to do next."
• Thirty-four days later, the Department sent a letter to Taxpayer's representative indicating that Taxpayer should supply the requested records within three weeks – the end of January 2011.
• In early February 2011, having failed to obtain Taxpayer's financial records within the time requested, the Department's auditor proceeded to conduct a "Best Information Available" (BIA) audit based on Taxpayer's federal income tax returns.
• The BIA audit was completed in Mid-March of 2011.

Taxpayer concludes that the Department's assessment and audit process was "reckless," that the Department did not follow established procedure to obtain the records, and that Taxpayer's requests to postpone the on-site audit examination were entirely reasonable. Taxpayer further maintains that the Department's audit assessment was fundamentally flawed because the Department failed to obtain a subpoena requiring the production of its financial records and that the Indiana Office of Attorney General failed to obtain a court order requiring the production of those records.

As authority for its position, Taxpayer cites to IC § 6-8.1-3-12 which states in relevant part:

(a) The department may audit any returns filed in respect to the listed taxes, may appraise property if the property's value relates to the administration or enforcement of the listed taxes, may audit gasoline distributors for financial responsibility, and may investigate any matters relating to the listed taxes.
(b) The department may audit any returns with respect to the listed taxes using statistical sampling. If the taxpayer and the department agree to a sampling method to be used, the sampling method is binding on the taxpayer and the department in determining the total amount of additional tax due or amounts to be refunded.
(c) For purposes of conducting its audit or investigative functions, the department may:
(1) subpoena the production of evidence;
(2) subpoena witnesses; and
(3) question witnesses under oath. The department may serve its subpoenas, or it may order the sheriff of the county in which the witness or evidence is located to serve the subpoenas.
(d) The department may enforce its audit and investigatory powers by petitioning for a court order in any court of competent jurisdiction located in the county where the tax is due or in the county in which the evidence or witness is located. If the evidence or witness is not located in Indiana or if the department does not know the location of the evidence or witness, the department may file the petition in a court of competent jurisdiction in Marion County. The petition to the court must state the evidence or testimony subpoenaed and must allege that the subpoena was served but that the person did not comply with the terms of that subpoena. (Emphasis added).

The Department is unable to agree that it was required to obtain a subpoena and/or a court order requiring the production of the records necessary to conduct the audit review. Certainly, IC § 6-8.1-3-12 provides the option of obtaining a subpoena or court order, but nothing in the law requires that the Department take that step before issuing a proposed assessment.

IC § 6-8.1-5-1(b) provides the Department with authority to issue an assessment based upon the "best information available."

If the department reasonably believes that a person has not reported the proper amount of tax due, the department shall make a proposed assessment of the amount of the unpaid tax on the basis of the best information available to the department.

The Department does not dispute Taxpayer's contention that it was appropriate to initially delay the commencement of the audit because of an employee's family related manner, that October was Taxpayer's "busy season," and that an October audit would "be unduly burdensome... to submit to an audit at [that] time of year...." However, based upon the available information as outlined above, it is plain that there was an eight-month communications failure which unreasonably delayed the completion of the audit and which made it necessary to conduct an audit based solely upon Taxpayer's income tax returns which – at the time the audit was completed – constituted the "best information available."

It should be noted that, Taxpayer had the statutory responsibility to maintain books and records necessary to determine its tax liability and to allow the Department access to those records. IC § 6-8.1-5-4 states:

(a) Every person subject to a listed tax must keep books and records so that the department can determine the amount, if any, of the person's liability for that tax by reviewing those books and records. The records referred to in this subsection include all source documents necessary to determine the tax, including invoices, register tapes, receipts, and canceled checks.

(b) A person must retain the books and records described in subsection (a), and any state or federal tax return that the person has filed:

(1) for an unlimited period, if the person fails to file a return or receives notice from the department that the person has filed a suspected fraudulent return, or an unsigned or substantially blank return; or

(2) in all other cases, for a period of at least three (3) years after the date the final payment of the particular tax liability was due, unless after an audit, the department consents to earlier destruction. In addition, if the limitation on assessments provided in section 2 of this chapter is extended beyond three

(3) years for a particular tax liability, the person must retain the books and records until the assessment period is over.

(c) A person must allow inspection of the books and records and returns by the department or its authorized agents at all reasonable times. (d) A person must, on request by the department, furnish a copy of any federal returns that he has filed.

The Department does not agree that within the eight months during which the Department sought permission to obtain access to Taxpayer's books and records, there was never a "reasonable time" in which to allow review of those records.

In addition, the Department directs Taxpayer to IC § 6-2.5-9-8 which states, "All records of a person that have collected or that should have collected gross retail taxes shall be kept open for examination at any reasonable time by the department or the department's authorized agents. A person that violates this subsection commits a Class D felony."

Common sense and common decency requires that the Department take reasonable steps to accommodate an individual Taxpayer's personal and business concerns when conducting an audit. However, Indiana law also requires that Taxpayer allow the Department to examine that Taxpayer's business records; Taxpayer failed to do so and it cannot now be heard to complain that it is dissatisfied with the result.

FINDING

Taxpayer's protest is respectfully denied.

II. Reasonable Cause – Gross Retail Tax.

DISCUSSION

Taxpayer argues that the Department's assessment is "defective and contrary to law" because there was never any "reasonable cause" to believe that Taxpayer owed additional sales/use tax.

As a threshold issue, it is the Taxpayer's responsibility to establish that the tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made."

To understand, the nature of the Taxpayer's "use tax" assessment, it is necessary to review the fundamental relationship between the state's "sales" tax and its "use" tax. Indiana imposes an excise tax called "the state gross retail tax" (or "sales tax") on retail transactions made in Indiana. IC § 6-2.5-2-1(a). A person who acquires property in a retail transaction (a "retail purchaser") is liable for the sales tax on the transaction. IC § 6-2.5-2-1(b).

Indiana also imposes a complementary excise tax called "the use tax" on "the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction." IC § 6-2.5-3-2(a). "Use" means the "exercise of any right or power of ownership over tangible personal property." IC § 6-2.5-3-1(a). The use tax is functionally equivalent to the sales tax. See Rhoade v. Ind. Dep't of State Revenue, 774 N.E.2d 1044, 1047 (Ind. Tax Ct. 2002).

By complementing the sales tax, the use tax ensures that non-exempt retail transactions (particularly out-of-state retail transactions) that escape sales tax liability are nevertheless taxed. Rhoade, 774 N.E.2d at 1047; USAir, Inc. v. Ind. Dep't of State Revenue, 623 N.E.2d 466, 468–69 (Ind. Tax. Ct. 1993). The use tax ensures that, after the goods arrive in Indiana, the retail purchasers of the goods bear their fair share of the tax burden. To trigger imposition of Indiana's use tax, tangible personal property must (as a threshold matter) be acquired in a

retail transaction. Id. A taxable retail transaction occurs when; (1) a party acquires tangible personal property as part of its ordinary business for the purpose of reselling the property; (2) that property is then exchanged between parties for consideration; and (3) the property is used in Indiana. See IC § 6-2.5-1-2; IC § 6-2.5-4-1(b), (c); IC § 6-2.5-3-2(a).

Taxpayer is correct in asserting that the Department may not issue a proposed assessment unless there is a reasonable belief that tax is owed. As set out in IC § 6-8.1-5-1(b) an assessment may be issued based upon the "best information available" under the following required conditions.

> If the department reasonably believes that a person has not reported the proper amount of tax due, the department shall make a proposed assessment of the amount of the unpaid tax on the basis of the best information available to the department.

Based upon the information available on its federal income tax returns, the Department believed that Taxpayer had purchased tangible personal property subject to the state's use tax during the years at issue. In the absence of any specific information to the contrary, the federal returns indicated that Taxpayer incurred purchase expenses. Whether or not those acquisitions were exempt or whether they were taxable was best determined by examining the original records which, of course, were never made available to the Department's auditor.

Taxpayer invites the administrative review to second-guess the auditor's determination that Taxpayer owed use tax. Taxpayer does not propose that Taxpayer owes a lesser amount of use tax but that Taxpayer owes zero use tax and it is this conclusion that the Department is unable to reach. It is Taxpayer's statutory responsibility to demonstrate that the proposed assessment is wrong and this it has failed to do.

FINDING

Taxpayer's protest is respectfully denied.

III. Statutory Authority – Gross Retail Tax.

DISCUSSION

Taxpayer argues that the Department's assessment of tax is erroneous on the ground that the audit's report indicated that Taxpayer owed "use" tax while the notices of proposed assessment indicated that Taxpayer owed "sales" tax. Taxpayer concludes that because of the discrepancy between the audit report and the notices, the assessment should be abated in its entirety.

As set out in Part II above, Indiana imposes both a sales tax on retail transactions made in Indiana. IC § 6-2.5-2-1(a). Indiana also imposes a "complementary" excise tax commonly called "the use tax" on "the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction." IC § 6-2.5-3-2(a). The audit determined that Taxpayer had evidently purchased items subject to sales tax but for which no sales tax was collected. Therefore the audit concluded that Taxpayer owed "use" tax based on the premise that those items were "used" in Indiana. See IC § 6-2.5-1-2; IC § 6-2.5-4-1(b), (c); IC § 6-2.5-3-2(a).

Assuming for the moment that consistency between the audit summary and the proposed assessment would have been preferable, Taxpayer has failed to demonstrate how this apparent inconsistency harmed Taxpayer or that the inconsistency should lead to abatement of the assessment. IC § 6-8.1-5-1(c) requires that the proposed assessment be presumed correct and that Taxpayer is required to prove the assessment is "wrong." Taxpayer has failed to do so.

FINDING

Taxpayer's protest is respectfully denied.

IV. Calculation Error – Gross Retail Tax.

DISCUSSION

Taxpayer maintains that the audit report contains two calculation errors. The first purported error is found on page four of the audit workpapers and is contained in the calculation of Taxpayer's expenses as set out in the Taxpayer's federal return for 2010. Taxpayer maintains that the total amount listed is mathematically incorrect. The audit report indicates that the total amount of claimed expenses is approximately $338,000 but that the correct figure is approximately $207,000. On this first purported error, Taxpayer is correct. The listed figures do contain an obvious calculation error and should be corrected.

The second purported error also relates to the audit's reliance on the Taxpayer's federal returns. The Department based its assessment on the amount of "projected taxable purchases" for each of the three years at issue. According to the audit report, the "expense accounts that were chosen [were] accounts that potential use tax should be paid per 45 IAC 2.2-5-8(j)...."

The portion of the administrative code upon which the audit relied read as follows:

> Managerial, sales, and other non-operational activities. Machinery, tools, and equipment used in managerial sales, research, and development, or other non-operational activities, are not directly used in manufacturing and, therefore, are subject to tax. This category includes, but is not limited to, tangible personal property used in any of the following activities: management and administration; selling and marketing; exhibition of manufactured or processed products; safety or fire prevention equipment which does not have an immediate effect on the product; space heating; ventilation and cooling for general temperature control; illumination; heating equipment for general temperature control; and shipping and loading. Id.

Taxpayer objects on the ground that the expenses reported on the federal form 1120 include items for which no sales/use tax was due such as "educational seminars," "insurance," "commissions," and "bank charges." In addition, Taxpayer points out the federal expenses include line items for which sales tax should have been paid to the original vendor such as "computer software," "office supplies," "advertising," and "utilities."

Taxpayer is correct to the extent that there may indeed be expenses on the federal attachment which details transactions which were plainly not subject to sales/use tax. However, it is not known if the Department's representative had access to this detailed information, but it is also not known whether Taxpayer possessed the underlying documentation necessary to verify that information. That verification and examination process is central to conducting a successful audit, and that process was forestalled by Taxpayer's failure to supply the requested information during the eight months that the Department attempted to obtain Taxpayer's records. The Department acted well within its authority under IC § 6-8.1-5-1(b) to issue a proposed assessment based upon the information it had on hand.

FINDING

Taxpayer's protest is sustained in part and denied in part.

SUMMARY

The audit division is requested to review the total 2010 expenses as found on page four of the audit workpapers and to make whatever correction is warranted. In all other respects, Taxpayer's protest is denied.

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